

Unrelated debt-financed income; co-owner indebtedness. An organization, exempt under section 501(c)(3) of the Code, that acquires an undivided interest in rental property subject to a mortgage and prepays its proportionate share of the mortgage indebtedness, receiving releases of liability from the mortgagee and co-owners, has no acquisition indebtedness within the meaning of section 514(c)(1) even though the entire property remains encumbered by the mortgage.

Advice has been requested whether, under the circumstances described below, an organization exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 has 'acquisition indebtedness' within the meaning of section 514(c)(1) with respect to its undivided interest in certain property.

The organization is exempt from Federal income tax under section 501(c)(3) of the Code and is the owner of an undivided 35-percent interest in certain rental property. The other 65 percent of the property is owned by private individuals. The property was acquired by the owners subject to a mortgage of 1,000x dollars, of which the organization's proportionate share was 350x dollars. The property is income-producing and is leased for purposes that are not related to the organization's exempt purposes.

In order to liquidate its share of the mortgage, the organization entered into two agreements, one with the financial institution that holds the mortgage and the other with the co-owners of the property. Under the terms of the first agreement, the organization prepaid its proportionate share of the mortgage indebtedness in exchange for the mortgagee's release of the organization from any further payment obligation under the mortgage. Under the second agreement, the other co-owners of the property released the organization from all payment obligations associated with the mortgage indebtedness. At the time of the second agreement, the releasing co-owners were clearly able to meet the remaining payment obligations.

However, the lien securing payment of the mortgage extends to the entire rental property, and the mortgagee will not release the lien until the entire principal of the mortgage is paid by the other co-owners.

Section 514(c)(1) of the Code defines the term 'acquisition indebtedness' as including, with respect to any debt-financed property, the unpaid amount of the indebtedness incurred by the organization in acquiring or improving such property.

Section 514(c)(2) of the Code and section 1.514(c)-1(b)(1) of the Income Tax Regulations provides that where property is acquired subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered as indebtedness of the organization incurred in

acquiring such property even though the organization did not assume or agree to pay such indebtedness.

In this case, even though the entire property is still encumbered by the lien of the mortgagee, the organization has taken steps necessary to release itself from all indebtedness under the mortgage. By liquidating its proportionate share of the outstanding indebtedness and by securing releases of its financial obligations under the mortgage from the mortgagee and the other co-owners, the organization has satisfied the full amount of its indebtedness. Accordingly, the organization has no acquisition indebtedness within the meaning of section 514(c)(1) of the Code with respect to its undivided interest in the property.